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Vincent Keith Schubert

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*By Vincent Keith Schubert**

The purpose of article XV, section 1 of the California Constitution has been consistently recognized by the courts as a protection for the unwary and necessitous borrower. This note will examine the diminution of the protection afforded by the scheme of the California Usury Law inherent in a recent California Supreme Court decision, *McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[1] which deals with the role of the element of intent in a usury law violation. An examination of the California courts' traditional approach to intent and an analysis of the supreme court's recent departure from that approach will demonstrate the potential vulnerability of the plaintiff borrower. *McConnell* contains an important holding regarding the loan period relevant to measuring the effective rate on a variable-interest loan. It also contains unfortunate dicta that, if followed, could greatly increase the plaintiff borrower's difficulty in showing intent on the part of the lender.

The litigation in *McConnell* involved a loan agreement which contained provisions for a variable interest rate. A variable interest rate means the rate of interest is not fixed at the time the loan is executed but is allowed to float at different levels over the life of the loan. The loan agreement itself should specify an external indicator to which the interest rate is tied. For instance, in *McConnell*, the interest rate was designated to be the federal "call money rate"[2] plus a certain additional per cent per year which varied depending on the size of the account balance.

Two aspects of the *McConnell* case are relevant to the consideration of the effect that the case could have on the element of intent. First, traditional methods of calculating the amount of interest paid as a means of determining the interest rate charged to the borrower do not yield meaningful figures when both the period of the loan and the interest rate are indeterminate. However, such interest calculations are

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* B.A., 1972, Stanford University. Member, Third Year Class.

1. 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978).
2. *Id.* at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373. The federal call-money rate is the rate of interest which Merrill Lynch was charged for brokerage loans.

necessary when the question at issue is the usurious character of the interest charged.[3] The trial court followed the traditional method and came to the conclusion that the McConnells had not been charged usurious interest.[4] The supreme court reversed a grant of Merrill Lynch's demurrer stating that the accepted method of averaging was inappropriate in the context of a variable-interest-rate loan.[5]

The second significant aspect of *McConnell* is the standard that the court suggests as a substitute for the traditional objective test in the determination of usurious intent. The court stated in dictum that in situations like *McConnell*, the requisite intent is not present when the lender has negotiated the agreement "in good faith and without intent to avoid the usury law."[6] In support of this exception to the presumption of intent, the court cited a line of cases dealing with the problem of contingent interest[7] and applied the reasoning of those contingent-interest cases to a loan involving variable interest. Despite some similarities between the concepts of variable interest and contingent interest, they are not economically or legally equivalent and should not be treated as though they are interchangeable.[8] Although the literal language of the contingent-interest cases appears applicable to the situation in *McConnell*, the failure of the court in *McConnell* to properly analyze the question of intent has led to the creation of a previously undefined and ambiguous exception to the presumption of intent in usury cases.

The Facts in McConnell

The McConnells were customers of Merrill Lynch who traded securities on margin.[9] In order to facilitate trading, Merrill Lynch advanced to customers like the McConnells funds that were placed in the customer's margin accounts. These advances, called brokerage loans, were made under an agreement which contained the following terms:

> The monthly debit in my balance account(s) shall be charged, in accordance with your usual custom with interest at a rate which shall

3. See notes 40-51 & accompanying text *infra*.
4. See notes 36-39 & accompanying text *infra* .
5. See notes 44-51 & accompanying text *infra*.
6. 21 Cal. 3d at 380, 578 P.2d at 1384, 146 Cal. Rptr. at 380.
7. Contingent interest involves a situation in which all, or a substantial portion, of the lender's return as interest is at risk. For a discusssion, see notes 59-61 & accompanying text *infra*.
8. See note 63 & accompanying text *infra*.
9. Margin trading is the purchase of stock where less than the full purchase price is paid by the purchaser. The term "margin" refers to the percentage of the purchase price which the buyer must actually give to the seller. If the buyer must pay 80% of the purchase price, there is an 80% margin. Even though the buyer has not paid full price, he realizes both the profit and loss on the entire block of stock which he owns.

include the average rate paid by you on your general loans during the period covered by such balances respectively, and any extra rate caused by market stringency, together with a charge to cover your credit service and facilities.[10]

In computing the interest the defendant ascertained the federal call-money rate, and added a service charge ranging between .5% per year for debit balances over $35,000 and 1.5% per year for balances under $10,000. At all times relevant to the suit, the McConnell's debit balance was under $10,000, and consequently was bearing interest at a rate of 1.5% over the call-money rate.

During the summer of 1973, the call-money rate increased to 8.25% on July 5th and 10% on September 4th. As a consequence, the average interest charged to the plaintiffs for the period from July 5, 1973, to September 26, 1973 exceeded 10% per year.[11] As of September 26, Merrill Lynch had applied for and received a personal property brokers' license and the concomitant exemption from the usury law.[12]

Plaintiffs filed suit individually and on behalf of a class of all California customers who maintained margin accounts with the defendant from November 26, 1971, to September 26, 1973, and who were charged allegedly "unlawful" interest.[13] In ruling on the certification of the class, the trial court made a determination that the proper class to pursue such a suit included only those customers who had maintained an account with Merrill Lynch and had been charged with a rate of interest in excess of 10% *for the entire period of the loan*.[14] When the interest in excess of the 10% maximum that was charged to the McConnells' account during the three-month period from July, 1973, to September, 1973, was averaged over the life of the McConnell's account, the total interest charged was under 10%. Thus the only members of the class with standing to bring a suit for the recovery of the usurious

10. 21 Cal. 3d at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373. Two separate provisions in the loan agreement led to two causes of action in *McConnell*. First, under the rubric "usual custom" the defendant's policy was to add the interest owing at the end of each month to the debit balance of the customer's account which would then bear interest in the following month. This constitutes compounding of the interest on a monthly basis. Charging compound interest requires an express clause in the loan agreement. *Id.* In reversing the order of the trial court sustaining the defendant's demurrer, the supreme court held as a matter of law that the customer agreement was not sufficiently clear to comply with § 2 of the usury law and that plaintiffs had succeeded in stating a cause of action for violation thereof. *Id.* at 369, 578 P.2d at 1377, 146 Cal. Rptr. at 373. This issue is not relevant to the court's consideration of the question of intent.

11. *Id.* at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373.

12. See note 70 *infra*. The Personal Property Brokers Law is part of a complete gridwork of statutes which grant exemptions to most institutional lenders. For a general discussion of California's usury law, see Note, *A Comprehensive View of California Usury Law*, 6 Sw. U.L. Rev. 166 (1974).

13. 21 Cal. 3d at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373.

14. *Id.* at 371-72, 578 P.2d at 1378-79, 146 Cal. Rptr. at 374-75.

interest were those members who had opened accounts shortly before July of 1973 and had closed their accounts shortly after September of 1973.[15] The McConnells, named plaintiffs in the present action, were not included in this class, and the court issued an order dismissing plaintiffs' suit as both a class and an individual action.[16]

Averaging Interest under the French Case

In making the determination that interest should be averaged over the entire period of the loan, the trial court relied on the reasoning of a line of cases represented by *French v. Guarantee Trust Co.*.[17] The *French* case enunciated the principle that the interest on a loan should be averaged over the entire contemplated life of the loan agreement in order to prevent a borrower from transforming an innocent transaction into a usurious one by default or premature payment.[18]

In effect, under some circumstances, repayment of the principal can be accelerated and the interest that has been assessed for the loan to date is then judged against a decreased principal amount. The acceleration takes place either from prepayment by the borrower or from some type of borrower default. In either case the contingency that results in the payment of usurious interest is an event within the control of the borrower. The courts are consistent in stating that such control by the borrower acts as a type of estoppel preventing the borrower from asserting the usurious character of the loan.[19]

The cases which rely on the rule of *French v. Guarantee Trust Co.* all involve situations in which compensation has been paid to the lender in addition to the interest stated on the face of the agreement. This additional compensation can be divided into two basic categories. The first category includes charges on the account that represent compensation for services actually rendered by the lender to the bor-

15. *Id.*

16. *Id.* at 371-72, 578 P.2d at 1378, 146 Cal. Rptr. at 374.

17. 16 Cal. 2d 26, 104 P.2d 655 (1940).

18. *Id.* at 32, 104 P.2d at 658. The *French* case itself involved a loan agreement where the life of the loan was expected to be approximately 10 years. The principal of the loan was advanced to the borrower in installments but the interest was assessed from the beginning of the loan period. Difficulties developed over the terms of the loan as well as those in a collateral construction agreement. When these difficulties proved insurmountable, the loan agreement was liquidated within a year, prior to the time when all of the principal had been extended to the borrower. As a result of these developments, the interest which was assessed for the initial year was considerably more than the 10% maximum. However, the court felt that the borrower should not be able to take advantage of a contingency which was within his control, namely premature payment, to alter the nature of the transaction. *Id.* at 26-30, 104 P.2d at 655-57.

19. *Id.* at 31-33, 104 P.2d 655, 657-58 (1940). *See also* Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 290-91, 134 Cal. Rptr. 456, 464 (1976) (citing Bush v. Sikking, 131 Cal. App. 703, 704, 21 P.2d 1013, 1013 (1933)).

rower.[20] The second category of additional compensation involves some type of prepayment penalty or default acceleration, as was present in the *French* case itself. Both types are legally chargeable to the loan account and represent expense to the lender for the entire period of the loan.[21] Logically, such charges should therefore be averaged over the entire loan period when making a determination as to the usurious nature of the interest charged.

The facts in *McConnell* differ significantly from those in *French*. Although borrower default in the *French* case led to a premature loan repayment, the loan agreement did state a fixed term for the life of the loan. The loan agreement in *McConnell* contemplated both an indefinite term and an indefinite balance. The agreement in *French* contained a fixed interest rate whereas the agreement in *McConnell* contained a variable interest rate. Because of these differences the reasoning of the *French* case is extremely difficult to apply, and a variable-interest-rate case should distinguish *French*.

This conclusion was reached by the California Supreme Court. In analyzing the variable-interest-rate loan in *McConnell*, the supreme court relied on the reasoning of *Arneill Ranch v. Petit*,[22] a recent case from the Court of Appeal for the Second District. In *Arneill*, Justice Potter pointed out the underlying incompatibility of the *French* rationale and variable interest. Justice Potter concluded that even though the interest paid for the full term of the loan did not exceed 10% per year, this alone did not guarantee that the loan was not usurious.[23] The *Arneill* court was careful to make a distinction between the type of case represented by *French* and the situation wherein the amount paid during any particular loan period exceeds 10% per year and represents only interest for that particular loan period.[24] For instance, in *Arneill*, interest payments were to be made on a semiannual basis. When the interest payment for one six-month period exceeded 10% per year, and when these charges did not represent the type of surcharge present in *French*, the interest paid to the lender during that single period was the proper measure for the interest rate in determining the usurious nature of the loan.[25]

In *McConnell*, the supreme court approved this analysis of variable-interest-rate loans[26] and adopted it in analyzing the situation in

20. Forte v. Nolfi, 25 Cal. App. 3d 656, 681, 102 Cal. Rptr. 455, 471 (1971).

21. 16 Cal. 2d at 32-33, 104 P.2d at 657-58. *See also* Abbot v. Stevens, 133 Cal. App. 2d 242, 247-50, 284 P.2d 159, 161-63 (1955).

22. 64 Cal. App. 3d 277, 134 Cal. Rptr. 456 (1976).

23. *Id.* at 293, 134 Cal. Rptr. at 466.

24. *Id.* at 289-93, 134 Cal. Rptr. at 463-66.

25. *Id.* at 293, 134 Cal. Rptr. at 466.

26. 21 Cal. 3d at 376, 578 P.2d at 1381, 146 Cal. Rptr. at 377.

that case.[27] The *McConnell* court stated that, in those situations when a variable-interest-rate loan agreement provided for an indefinite, total time period, the method of averaging utilized in the *French* case was inapplicable.[28] On this basis, the supreme court reversed the trial court's grant of the demurrer and remanded the case.[29] However, the court felt compelled to add its views in dictum on the question of intent, an issue to be considered on retrial.

Having determined that the *French* method of characterization was inapplicable, and having adopted the *Arneill* analysis of variable-interest-rate payments, the court had disposed of all the issues presented on appeal. The court, however, went beyond the issues presented and, in addition to any mathematical calculation of interest, *McConnell* now adds a new dimension to usury cases by redefining the nature of the requirement of intent as an element of a usury law violation.[30] The borrower must now make an affirmative showing of a lack of good faith under circumstances which should allow for a presumption of intent. In order to understand the court's redefinition of this element of intent, an examination of the traditional approach to this question is necessary.

The Presumption of Intent and the Exceptions for Good Faith

The burden of proof to show the existence of the intent to exact usurious interest rests on the party asserting the usurious character of

27. *Id.* at 376-77, 578 P.2d at 1381-82, 146 Cal. Rptr. at 377-78. The court does not specifically address the question of what is the proper method of calculating the amount of interest in the context of a variable-interest-rate loan. This author recommends that, as a minimum protection for the borrower, interest should be calculated on an annual basis. When the amount of interest paid during a one-year period exceeds 10%, the borrower should be able to take advantage of the presumption of intent when the lender consciously accepts the excess interest.

In the alternative, when the interest payments are made periodically, the usurious character of the payment can be determined for any period by annualizing the rate. Whenever the interest consciously accepted by the lender during any loan period exceeds 10%, the borrower should have the advantage of the presumption.

Unfortunately, the presence of the language in regard to good faith that appears in *McConnell* makes it possible to interpret that case as establishing an exception to the presumption of intent regardless of the level reached by the interest rate in a variable-interest-rate agreement. The wording of the opinion also indicates that the court envisions an affirmative showing of a lack of good faith on the part of the lender before a recovery will be allowed. *Id.* at 380, 578 P.2d at 1384, 146 Cal. Rptr. at 380. The implications of this requirement are discussed *infra*. *See* note 69 & accompanying text *infra*.

28. 21 Cal. 3d at 377, 578 P.2d at 1381-82, 146 Cal. Rptr. at 377. The court here is stating the obvious. When the agreement itself is of indeterminate length there is no way in which a total loan period can be calculated.

29. *Id.*

30. *Id.* at 377-78, 578 P.2d at 1382-83, 146 Cal. Rptr. at 378.

the transaction.[31] California courts recognized early in the history of California's usury law that as a practical matter showing an intent to violate the law would be an impossible burden.[32] It would require a virtual confession from the lender as well as a showing that the defendant possessed a knowledge of the law.

This harsh rule was alleviated by presuming intent when the loan agreement itself discloses usurious terms.[33] This presumption is based on a general rule that the parties intend to do those acts that are in fact performed.[34] If the terms of the agreement call for interest at a rate greater than 10% per year, and the lender consciously accepts payment of this amount, his intent in relation to the usury law per se is irrelevant. As expressed in *Burr v. Capital Reserve Corp.*:[35] "Although intent is an element of usury, a conscious attempt to evade the usury law is not necessary, and usury may be found where there has been only a conscious and voluntary taking of more than the legal rate of interest."[36]

Once an agreement is determined to be a loan transaction that calls for more than the legal rate of interest on its face, most courts[37] and commentators[38] agree that intent is presumptively established and that any further consideration of the intent of the parties is irrelevant.

However, the presumption of intent is predicated on the existence of a loan. In many cases, an analysis of the nature of the transaction will be necessary in order to determine whether the transaction is a loan or not.[39] When such an analysis is necessary, inquiry into the intent of the parties is not foreclosed by presumption. When the nature of the transaction is at issue, if the parties have negotiated the agreement in good faith and without intent to evade the usury law, this will be a sufficient indication that the transaction was not a loan and there will be no usury law liability. The concept of intent should properly be formulated: intent to receive on money loaned, consciously and voluntarily, an amount of interest in excess of the statutory maximum. There are two exceptions. The first exception involves charges which can le-

31. Sandell, Inc. v. Bailey, 212 Cal. App. 2d 920, 931, 28 Cal. Rptr. 413, 420, *cert. denied*, 374 U.S. 831 (1963).

32. *See* Martin v. Kuchler, 212 Cal. 536, 299 P. 52 (1931).

33. *Id.* at 539, 299 P. at 53.

34. Maze v. Sycamore Homes, Inc., 230 Cal. App. 2d 746, 751, 41 Cal. Rptr. 338, 342 (1964).

35. 71 Cal. 2d 983, 458 P.2d 185, 80 Cal. Rptr. 345 (1969).

36. *Id.* at 989, 458 P.2d at 189, 80 Cal. Rptr. at 349.

37. *See, e.g.*, Burr v. Capital Reserve Corp., 71 Cal. 2d 983, 989, 458 P.2d 185, 189, 80 Cal. Rptr. 345, 349 (1969).

38. 14 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1698 (3d ed. 1972); RESTATEMENT OF CONTRACTS § 526, Comment b (1932); 6A A. CORBIN, CORBIN ON CONTRACTS § 1501 (1962).

39. See notes 67-78 & accompanying text *infra*.

gally and logically be averaged over the life of the loan, *e.g.*, the type of surcharge seen in the *French* case.[40] The second exception is the inquiry into the nature of the transaction as noted above. This inquiry takes place in two basic situations.

First, transactions that on their face do not appear to involve a loan or forebearance of money are condemned when an analysis of the intent of the parties reveals that the transactions are actually usurious loans masquerading as transactions to which the usury law does not apply.[41] Second, loans that are apparently usurious, but which involve a substantial risk to the lender, have been condoned as being more in the nature of speculation in a joint venture—the contingent-interest situation.[42]

In both these cases, intent serves as the vehicle for the analysis of the transaction. However, these two situations represent the only circumstances under which the "good faith" test has been used either to condone an apparently usurious transaction, or to condemn a transaction apparently not usurious. When the transaction is concededly a loan and there is no substantial risk to the lender the presumption applies—not the "good faith" test.

The statutory scheme of the California usury law envisions a lender either being subject to the 10% limit of the constitutional amendment or to regulation under the Financial Code.[43] *McConnell* adds a new dimension to a lender's defenses under a misapplication of the "good faith" standard for intent. Except for *Arneill*, a case on which the *McConnell* court relies heavily in its discussion of good faith,[44] intent has never before been used to insulate a nonexempt lender[45] from liability for a usury law violation when the agreement in question was clearly a loan and no extraordinary element of risk was present in the transaction to justify an excessive rate of interest.

40. See notes 17-18 & accompanying text *supra*.
41. See notes 47-49 & accompanying text *infra*.
42. See notes 58-60 & accompanying text *infra*.
43. See notes 71-72 & accompanying text *infra*.
44. The reliance of the court can be easily inferred from the repeated references to *Arneill* and from the fact that the same cases are cited by both courts. The *Arneill* court makes no distinction in its use of the words "variable" and "contingent," apparently relying on the fact that both concepts involve some element of change. However, variable interest and contingent interest are not identical concepts. For a discussion, see notes 62-63 & accompanying text *infra*. The supreme court adopts the *Arneill* analysis of variable and contingent interest without critical comment. See notes 22-27 & accompanying text *supra*.
45. A nonexempt lender is a lender without an exemption from the usury law.

The Good Faith Test

The Nature of the Transaction

In many cases dealing with modern financial transactions, the true nature of the agreement between the parties is difficult to determine. Many arrangements can obscure what is in reality a loan. A purported lease can often be a security agreement; a purported consignment can in actuality be a conditional sale.[46] Since the usury law covers only a loan or forbearance of money,[47] a lender with usurious intent could avoid the legal maximum limitations on the rate of interest by structuring a loan agreement so that it appears to be something else. The courts have not been receptive to this type of machination.[48]

The difficulty arises when an agreement that is basically a loan is characterized as some other type of transaction. In such situations the court should determine whether the transaction in question is a valid lease or credit sale, or in fact, a loan. The courts examine all the facts surrounding the agreement to determine under what circumstances such transactions are usurious loans.

In some circumstances an examination of the agreement would disclose that no borrower would freely enter into certain aspects of the transaction in question. For instance, a simple loan agreement for less than the maximum amount of interest would only be extended if the borrower agreed to lease equipment from the lender at terms not justified in the regular course of business. When such collateral agreements are a condition for the extension of credit, a certain percentage of the profit to the lender under the lease agreement is actually interest that the lender is demanding for a loan of money.[49]

The focal point for such examination has become the intent of the parties, particularly the lender. If the bargaining was done in good faith, at arm's length, and without intent to evade the usury law, this would be a sufficient indication that the transaction was in fact what it purported to be.[50]

Two recent cases decided prior to *McConnell* demonstrate this use

46. *See, e.g.*, Burr v. Capital Reserve Corp., 71 Cal. 2d 983, 458 P.2d 185, 80 Cal. Rptr. 345 (1969).

47. Milana v. Credit Discount Co., 27 Cal. 2d 335, 339, 163 P.2d 869, 871 (1945); CAL. CONST. art. XV, § 1.

48. Boerner v. Colwell Co., 21 Cal. 3d 37, 44, 577 P.2d 200, 204, 145 Cal. Rptr. 380, 384 (1978). *But see* Verbeck v. Clymer, 202 Cal. 557, 562-63, 261 P. 1017 (1927), where the California court recognized the validity of the time-credit doctrine. Historically, this doctrine allowed a vendor of goods to establish one price for an immediate sale for cash, and a second price where he himself was extending credit to one of his customers. This doctrine has evolved into a general exception from the usury law for valid credit sales.

49. *See, e.g.*, Terry Trading Corp. v. Barsky, 210 Cal. 428, 292 P. 474 (1930).

50. See notes 51-57 & accompanying text *infra*.

of the concept of intent as an analytical tool. In *Glaire v. La Lanne-Paris Health Spa, Inc.*[51] the plaintiff urged in part that the customary sale of contracts at a discount constituted a loan and was subject to the limitations of the usury law. In overruling the trial court's grant of a demurrer, the supreme court noted the analytical use of intent:

> [T]he good faith of the parties is crucial to the insulation of discount transactions from usury consideration, and good faith is ultimately a question of fact: ". . . The courts have been alert to pierce the veil of any plan designed to evade the usury law and in doing so to disregard the form and consider the substance. . . . All of the negotiations, circumstances and conduct of the parties surrounding and connected with their contracts may be material *in determining whether the form thereof covered an intent to violate the usury law* . . . ."[52]

This use of the concept of intent in *Glaire* is entirely different from the use made of intent in *McConnell*. In *Glaire* a fairly complex financial transaction was revealed to be a disguised loan. In *McConnell*, there was no dispute about the nature of the transaction. The parties intended a loan of money. The issue in *McConnell* was the effect of the collection of interest in excess of the statutory maximum amount.

Boerner v. Colwell Co.[53] involves the same use of intent[54] demonstrated in *Glaire*. In discussing the distinction between credit sales and

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51. 12 Cal. 3d 915, 528 P.2d 357, 117 Cal. Rptr. 541 (1974). The borrower was the purchaser of a seven-year membership in a health club owned by the defendant. The plaintiff was offered a choice of making a full payment of $408 at the beginning of the term of the membership or of making 24 monthly payments of $17 each. Plaintiff, like most of the spa's customers, chose to make the monthly payments. As a matter of course, the spa discounted the note with the customer and assigned the contract to Universal Guarantee Acceptance Corporation for $225. Universal and La Lanne are interlocking corporations and Universal regularly assists La Lanne with financing.

52. *Id.* at 927, 528 P.2d at 364-65, 117 Cal. Rptr. at 548-49 (citing Milana v. Credit Discount Co., 27 Cal. 2d 335, 340-41, 163 P.2d 869, 871-72 (1945)) (emphasis added).

53. 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978).

54. Colwell Co. is a mortgage banking firm which regularly assisted several construction companies whose customers wished to secure financing for construction to be performed by the construction companies. Colwell would reach an agreement with the builders outlining the circumstances under which Colwell would purchase the construction contracts from the builder. Colwell supplied the builder with a series of forms including a credit application, a lien contract and deed of trust, and a truth-in-lending disclosure.

When a builder using Colwell's service was contacted by a homeowner who wished to have a construction job performed, a contract was executed by the builder and the customer, as well as all the forms which had been supplied by Colwell. Colwell would then run a credit check and if the results were satisfactory, Colwell would inform the builder and the homeowner that the contract was accepted for purchase and would record the assigned lien contract and deed of trust.

A group of homeowners who had financed construction in this way brought suit claiming that the sale of the contracts at a discount constituted a loan which was subject to the limitation of the usury law. Colwell asserted that the transaction were really valid credit sales and not loans by Colwell in the form of assignments.

loans, the court cited *Burr v. Capital Reserve Corp.*[55] for the proposition that intent is the proper focus for determining the nature of the transaction.[56] Although there is a split of opinion on the question of whether the record in the case reveals a loan transaction or not, there is no disagreement on the question of intent, and the dissent in *Boerner* contains the clearest formulation of the role of intent in analyzing the nature of the transaction. Justice Mosk stated:

> Where the form of the transaction makes it appear to be nonusurious, it is for the trier of fact to determine whether the intent of the contracting parties was that disclosed by the form adopted, or whether such form was a mere subterfuge to conceal a usurious transaction. . . . Thus, intent is material in determining the nature of the transaction; but once the true nature is shown, the intent with which the act was performed is immaterial. . . . In other words a conscious attempt to evade the Usury Law is not necessary.[57]

The Hazard Rule

The second situation in which good faith has been used as an exception to the presumption of intent revolves around a contingency which places all, or a substantial portion, of the lender's return as interest at risk. In some circumstances, an entrepreneur might wish to attract capital for a venture with high risk. In order to attract investors he will have to offer a rate of return commensurate with the risk. Although there are methods by which such investors could participate in the transaction without a loan agreement, *e.g.*, incorporation or limited partnership, investors may not be willing to assume the formal responsibilities required by these procedures. The simplest and most convenient form for such a transaction to take would be for the lender-investors to enter into a loan arrangement with the entrepreneur and to make his high interest return contingent on the success of the enterprise. Such an arrangement would violate the usury law if the interest rate were to exceed 10%.

However, usury law liability is predicated on the existence of a loan transaction. A transaction that involves substantial risk is more accurately characterized as a joint venture. The so-called "hazard rule" was developed by the courts as an exception to the usury law which was justified by the risk that the lender was willing to take. This risk was seen as a justification for the lender's demand of more than the legal maximum rate of interest in those situations where he was willing to indulge in a speculative endeavor; where the investor-lender is clearly investing as opposed to lending.

55. 71 Cal. 2d 983, 458 P.2d 185, 80 Cal. Rptr. 345 (1969).
56. 21 Cal. 3d at 44, 577 P.2d at 204, 145 Cal. Rptr. at 384.
57. *Id.* at 58, 577 P.2d at 213, 145 Cal. Rptr. at 393 (citations omitted).

Unfortunately, the form the parties choose for this type of transaction makes the agreement appear to be a usurious loan. In such circumstances, the courts have allowed the lender to use intent to demonstrate the true nature of the transaction.

Typical of this situation is the case of *Thomassen v. Carr*.[58] In that case the lender advanced a substantial sum of money for a period of eighteen months. The defendant was to use the money to make certain improvements on his real property. In lieu of interest the lender was to receive a percentage of the profit realized on the sale of the improved property. When a sale was eventually made, the lender's portion of the profit amounted to almost a 100% return on the lender's initial investment. However, the court determined that this "loan" was really more in the nature of speculation, and since any interest returned to the lender was subject to a substantial and recognizable risk, the usury law did not apply.

The line of cases represented by *Thomassen v. Carr*,[59] and supported by section 527 of the *Restatement of Contracts*,[60] represents an exception to the usury law which covers agreements designed to include this type of contingent interest. Provided that all, or a substantial portion, of the interest return on the investment is subject to a substantial risk, the parties will be deemed to have bargained in good faith and without intent to evade the usury law.

McConnell and Good Faith

In analyzing the *McConnell* case, it is apparent that none of the recognized exceptions to the usury law covers the Merrill Lynch agreement. The arrangement is clearly a loan. This obviates the necessity to use the concept of good faith to determine the form of the transaction.

58. 250 Cal. App. 2d 341, 58 Cal. Rptr. 297 (1967).

59. *See, e.g.*, Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 134 Cal. Rptr. 456 (1976); Thomassen v. Carr, 250 Cal. App. 2d 341, 58 Cal. Rptr. 297 (1967); Wooton v. Coerber, 213 Cal. App. 2d 142, 28 Cal. Rptr. 635 (1963); Schiff v. Pruitt, 144 Cal. App. 2d 493, 301 P.2d 446 (1956); Miley Petroleum Corp. v. Amerada Petroleum Corp., 18 Cal. App. 2d 182, 63 P.2d 1210 (1936); Lamb v. Herndon, 97 Cal. App. 193, 275 P. 503 (1929); Jameson v. Warren, 91 Cal. App. 590, 267 P. 372 (1928).

60. RESTATEMENT OF CONTRACTS § 527 (1932) provides: "A promise, made as the consideration for a loan or for extending the maturity of a pecuniary debt, to give the creditor a greater profit than the highest permissible rate of interest upon the occurrence of a condition, is not usurious if the repayment promised on failure of the condition to occur is materially less than the amount of the loan or debt with the highest permissible interest, unless a transaction is given this form as a colorable device to obtain a greater profit than is permissible. In that case it is usurious." The *Arneill* court cites *Thomassen v. Carr* for the proposition that *Restatement* § 527 states the law in California. 64 Cal. App. 3d at 289, 134 Cal. Rptr. at 463. Note, however, that this section has been deleted in RESTATEMENT (SECOND) OF CONTRACTS (Tent. Draft No. 12, 1977).

Under the rationale of the *Burr* case,[61] Merrill Lynch's intent vis-à-vis the usury law should be presumed as there is no issue as to whether Merrill Lynch intended to accept an amount of interest in excess of the legal maximum. This intent can be inferred from the actual collection of interest under the terms of the loan agreement.

The only other well defined exception from the usury law is the hazard rule, necessary in contingent-interest cases. However, the agreement in the *McConnell* case involved variable interest. The factors to which a trier of fact should look to interpret the agreement in contingent-interest cases are not present in a variable-interest case. Contingent interest cannot be equated, economically or legally, with variable interest.

The concept of contingent interest requires that the lender assume a certain amount of the risk in consideration for a potential rate of return enhanced beyond the statutory maximum. Allowing a borrower to enter into an agreement calling for contingent interest and, then when the enterprise succeeds beyond all expectation, allowing him to subject the lender to the penalties involved in a violation of the usury law would be unfair.

Variable interest, on the other hand, contains no element of risk. It is simply an attempt to tie the rate of return on a loan to an objective economic indicator that reflects with reasonable accuracy a reasonable rate of return. The object of a variable-interest-rate loan is not to provide for an unexpected contingency but to allow the interest rate to reflect inflationary or deflationary pressure without a necessity to refinance and thereby guarantee to the lender a profit on the transaction. This device would be particularly useful in situations like that in *McConnell* when both the amount of the loan and the period of the loan are indefinite. Variable interest is an economically feasible alternative to the normal fixed-rate loans[62] but bears no relation to contingent interest. Unlike contingent interest, which involves high risk, variable interest is designed to eliminate the uncertainty caused by inflation. Therefore, the court's reliance on the *Thomassen* line of cases as support for a good-faith exception for a variable-interest-rate loan is misplaced.

In effect, the court has now added another good faith exception to the presumption of intent. No previously defined exception covers a variable-interest-rate loan that rises above 10%. The standards for such

61. See notes 35-38 & accompanying text *supra*.

62. The California Civil Code already provides statutory standards and requirements for variable-interest-rate loans in real estate mortgages. *See* CAL. CIV. CODE § 1916.5 (West Supp. 1979). For a discussion of their uses and advantages, see Comment, *The Variable Interest Rate Clause and Its Use in California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468 (1972).

an exception are not well defined in *McConnell*.[63]

The court finds support for its holding in what it calls "practical good sense."[64] It recognizes that a strict construction of the usury law confronts a lender in Merrill Lynch's position with a difficult choice.[65] When the amount that the lender must pay in order to obtain funds to advance to its customers rises above 10% per year, the lender must choose between advancing money at rates below cost or calling in its margin loans. The court is clearly sympathetic to Merrill Lynch, going so far as to state gratuitously that the documents before it on appeal appear consistent with good faith.[66]

However, the reasoning of the court in its analysis of good faith entirely lacks case support. The cases cited in *McConnell* involve facts that are distinguishable to the point of irrelevancy.[67] None of the elements of risk of the contingent-interest cases, which justify an excessive rate of interest, will be present in a variable-interest-rate case.[68] The court has provided no guidance for determining the reasonable nature of the indicator selected by the parties, the effect of a relative disparity in bargaining power, or the weight to be given other factors in the context of a variable-interest-rate loan. The court should not create a new exception for lenders by relying on a line of cases that does not provide any guidance for the trier of fact to assess the grounds on which such an exception is to be judged.

Furthermore, Merrill Lynch had several options that it could have exercised in order to protect itself from a usury law violation. That they failed to do so could reasonably be taken as a demonstration of the necessary intent. A simple 10% cap could have been placed on its loan stating that should the indicator plus the surcharge rise above 10%

63. In an attempt to justify its position, the court felt constrained to point out that the benefits of a variable-interest-rate loan inure to the borrower as well as the lender. This statement assumes that the loan agreement contains an indicator similar to those used in real estate mortgages under the Civil Code. The Code requires that the variable-interest-rate clause in the mortgage must allow the interest rate to be decreased when the indicator drops as well as increased when the indicator rises. This requirement was necessary to protect mortgagors from escalator clauses, which only allow the interest rate to move up. Would the court find that such a clause did not comport with good faith? In addition, given the level of the inflationary pressure to which the economy has been subject in recent years, the benefits to the borrower which the court notes may be more illusory than real.

In defending variable-interest-rate loans the court seems to lose sight for a moment of the fact that the issue in the case is not the validity of the agreement but the effect of the collection of interest in excess of the legal maximum. Whether variable interest represents an advantage for the borrower is not relevant to the question of whether Merrill Lynch is guilty of usury.

64. 21 Cal. 3d at 378, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

65. *Id.*

66. *Id.*

67. See notes 59-63 & accompanying text *supra*.

68. See notes 58-60 & accompanying text *supra*.

interest would be collected at a rate of 10% per year rather than the higher figure. A more liberal ceiling could be placed on a variable-interest-rate loan by relying on the one-year period expressed in the constitution. If, at any time, the interest rate for the preceding one year exceeded 10%, interest would be limited by a 10% ceiling until the indicator plus the surcharge fell below 10% for the previous one-year period.[69]

An additional factor which reduces the necessity which the court apparently felt for establishing a new exception to the usury law is that the extensive scheme of exemptions for certain institutional lenders already includes lenders situated in Merrill Lynch's position. Merrill Lynch could easily have qualified for a personal property brokers' license at any time and thereby been exempt from the usury law. Obviously, as long as the call-money rate plus the surcharge was below 10%, there was no reason for Merrill Lynch to subject itself to the regulation of the Personal Property Brokers Law.[70] However, once the rate did begin to approach the limit, Merrill Lynch should have opted for the license. In fact, shortly after the rate did exceed 10%, Merrill Lynch applied for and received a license.[71]

In the period between the time when interest exceeded 10% and the issuance of the license, Merrill Lynch should have returned the excess interest collected or suffered liability for violating the usury law. This choice is mandated by the language of article XV, section 1 of the constitution. When a lender wishes to loan money he should be faced with the necessity of having his loan comply with the 10% limit of the constitution or with applying for a license and having his loan regulated under an appropriate section of the Financial Code. The *McConnell* court has now given a lender the additional option of remaining unregulated and relying on the nebulous good faith standard to insulate him from the usury law. This new option, coupled with the added difficulty the borrower now faces in proving his case, makes it possible that numerous lenders who should be forced under the regulation of the Financial Code will now choose to rely on the good faith of their negotiations. Despite what the court sees as the injustice of subjecting Merrill Lynch to liability under the usury law, such a solution is preferable to allowing a nonexempt lender (Merrill Lynch's status prior to receipt of the personal property brokers' license) to operate without

69. The court of appeal in *Arneill* pointed out that this situation did exist in fact in that case. However, after noting some confusion over the issue of characterization of interest payments, the *Arneill* court chose to dispose of the case on the same basis that the supreme court adopted in *McConnell.* Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 282-83, 134 Cal. Rptr. 456, 459-60 (1976).

70. CAL. FIN. CODE §§ 22000-22653 (West 1968).

71. 21 Cal. 3d at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373.

any restraint on the amount of interest which can be charged other than a nebulous and unsupported standard of good faith. As variable-interest-rate loans become a more significant factor in consumer transactions, borrowers dealing with nonexempt lenders in nonexempt transactions should not be deprived of the protection of the usury law.

Conclusion

Perhaps the most damaging consequence of the *McConnell* decision is the effect that its dictum will have on the plaintiff borrower's ability to successfully prove a usury law violation. The *McConnell* case now places any borrower whose loan transaction contains a variable-interest-rate clause in the same impossible position the objective-intent presumption was designed to alleviate.[72] In order to prove his case, the borrower must now obtain evidence of intent which the courts have repeatedly recognized is all but unobtainable.

The imposition of this burden contravenes the strong public policy of California against usury. The language of the Constitution states that in the absence of an exemption "[n]o person, association, copartnership or corporation shall . . . receive from a borrower more than 10 percent per annum upon any loan or forbearance of any money, goods or things in action."[73] If a trial court were now to follow the dictum in *McConnell* and impose the burden of proof on the question of intent on the plaintiff borrower, that burden would represent a significant infringement of the constitutional protection afforded California borrowers by the usury law.

The *McConnell* dictum is particularly open to criticism in that it is unnecessary for the court to create an exception from the usury law in order to relieve the economic pressure on Merrill Lynch. The Financial Code already contains perfectly satisfactory provisions in the Personal Property Brokers Law which cover lenders in Merrill Lynch's position. A protection for California borrowers that is constitutional in stature should be circumvented only with extreme care and under extraordinary circumstances. It should certainly not be weakened based on a dubious analogy to an irrelevant line of cases no matter how much "practical good sense" can be found to support one side of the case.

72. See notes 31-37 & accompanying text *supra*.
73. CAL. CONST. art. XV, § 1.